Georgia

Rising external demand in 2018 kept growth at 4.8% despite lower fiscal spending. Inflation decreased by more than half, and rapid tourism and export growth narrowed the current account deficit. Growth is projected to rise to 5.0% in 2019 with higher investment spending, then moderate slightly in 2020. Inflation will be slightly higher. Workforce skills must be improved to attract investment into more diverse and remunerative activities.

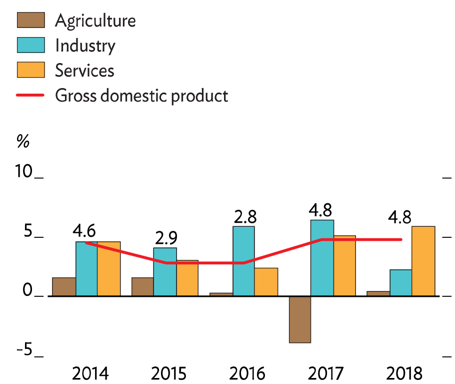
Economic performance

Growth continued at 4.8% in 2018 thanks to rising exports and tourism and despite slower expansion in infrastructure projects and worsening regional volatility, notably in neighboring Turkey. On the supply side, growth in industry slowed sharply from 6.4% in 2017 to 2.3% as a 2.5% decline in construction from lower capital spending offset gains of 4.1% in manufacturing and 10.8% in mining. Meanwhile, growth in services accelerated from 5.1% in 2017 to 5.9% on strong gains of 4.5% in trade, 17.9% in finance, and 9.8% in real estate. Agriculture rebounded from 3.8% contraction in 2017 to 0.4% growth as crop production improved with better weather (Figure 3.3.1).

On the demand side, estimated growth in consumption nearly tripled from 0.5% in 2017 to 1.4% as higher incomes increased private consumption by 2.5%, while public consumption fell by 2.5%. Growth in investment is estimated to have risen from 3.8% to 4.8% despite a slowdown in public investment. However, the estimated rise in net exports, while high, slowed from 20.1% to 17.8% as the growth in exports diminished and the expansion in imports accelerated.

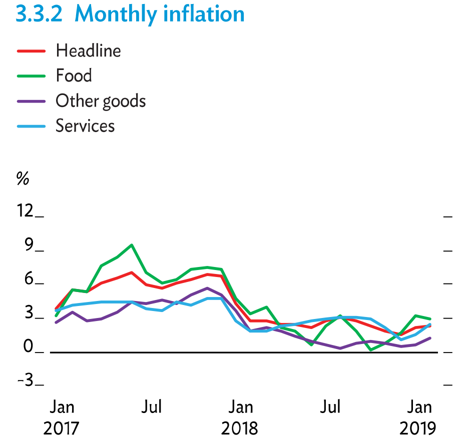
Average inflation fell by more than half from 6.0% in 2017 to 2.6% as the impact of higher excise taxes implemented in 2017 waned and the Georgian lari appreciated against the Turkish lira, easing prices for imported goods, in particular clothing and footwear. Inflation slowed for food from 6.8% in 2017 to 2.2%, for other goods from 5.0% to 1.3%, and for services from 4.7% to 2.4%. Some prices rose more quickly: for health care by 4.8% and, following electricity and water tariff increases in January 2018, for utilities by 4.3% (Figure 3.3.2). Core inflation excluding food and energy slowed from 4.0% in 2017 to 1.7%.

3.3.1 GDP growth by sector



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 22 February 2019).

3.3.2 Monthly inflation



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 7 March 2019).

This chapter was written by George Luarsabishvili of the Georgia Resident Mission, ADB, Tbilisi.

Prudent fiscal policy in 2018 helped narrow the deficit from the equivalent of 0.9% of GDP in 2017 to 0.8% (Figure 3.3.3). Tax collections were limited by accelerated refunds to firms of value-added tax estimated to equal 1.3% of GDP, causing tax revenue to fall from 25.8% of GDP to 25.4%—a smaller decline than expected—and trimming total revenue from 28.9% of GDP to 28.6%. Capital expenditure rose toward year-end, but current spending was lower as a law on civil service remuneration, adopted in December 2017, helped contain administrative costs. Total expenditure declined from 29.7% of GDP in 2017 to 29.4%. Public debt declined slightly from 44.2% of GDP at the end of 2017 to 43.4% a year later, with domestic public debt down from 9.3% of GDP in 2017 to 9.2%.

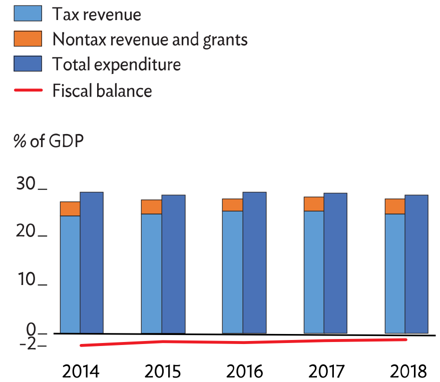
Monetary policy aimed to support growth as domestic demand remained moderate. The National Bank of Georgia, the central bank, reduced its policy rate by 0.25 percentage points in July 2018 to 7.0% and further to 6.75% in January 2019 as economic activity slowed, demand pressures on inflation abated, and the lari strengthened in nominal effective terms faster than expected with currency depreciation in the Russian Federation and Turkey. Tighter restrictions on lending contained borrowing, keeping credit growth broadly stable at 22.7% and slowing broad money growth marginally to 14.7% (Figure 3.3.4). Measures launched in 2017 to reverse dollarization held the share of loans in foreign currency at 56.1%, compared to 56.3% in 2017.

Banks remained well capitalized, liquid, and profitable with a capital adequacy ratio of 18.4%, return on equity of 23.3%, and return on assets at 3.0%. Nonperforming loans declined slightly from 2.8% of all credit in 2017 to 2.7%. Interest rates on Treasury securities decreased to 7.2%. Corporate debt was stable at 27.9% of GDP in 2018, but household debt continued to climb, reaching 33.7% (Figure 3.3.5).

Rapid export growth narrowed the current account deficit from the equivalent of 8.8% of GDP in 2017 to 8.0% despite higher profit repatriation. Exports of goods and services jumped by 18.5%, with receipts from tourism up by 18.4%, as demand increased from markets other than Turkey, where an economic crisis cut into Georgia's receipts from trade, tourism, and remittances. Imports expanded by 14.6% on rising oil prices earlier in the year. Net remittances increased by 15.1% to a record high of $1.4 billion, reflecting strong inflows from Greece, Israel, Italy, and the US.

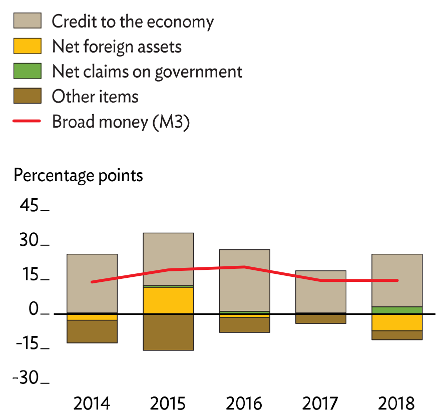
Current account financing came mainly from $1.2 billion in foreign direct investment, largely into construction, energy, transport, and finance. The lari appreciated against the US dollar in the first half of 2018 but retreated in the second half, ending up 2.1% weaker by year-end. However, the lari appreciated by 3.7% in nominal effective terms and 1.0% in real effective terms as it strengthened against the currencies of the

3.3.3 Fiscal indicators



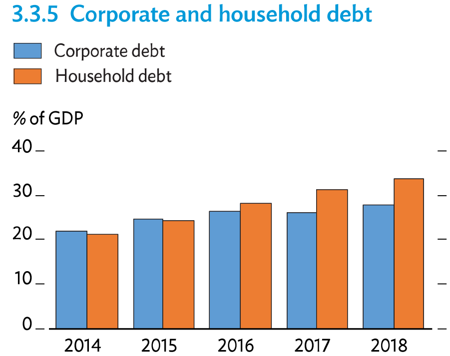
Sources: International Monetary Fund. www.imf.org; Ministry of Finance of Georgia. www.mof.ge (both accessed 22 February 2019).

3.3.4 Contributions to M3 broad money growth



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 20 February 2019).

3.3.5 Corporate and household debt



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 7 March 2019).

Russian Federation and Turkey (Figure 3.3.6). The central bank purchased $198 million in foreign currency during the year, boosting gross international reserves by 8.2% to $3.3 billion, for an adequacy ratio of 93% as defined by the International Monetary Fund. Public and publicly guaranteed external debt declined slightly from the equivalent of 34.9% of GDP at the end of 2017 to 34.2% a year later.

Economic prospects

Growth is forecast to rise to 5.0% in 2019 with higher infrastructure spending and then to slow marginally to 4.9% in 2020 with less growth in investment outlays (Figure 3.3.7). Net exports, consumption, and investment are all expected to support growth in 2019 and 2020, bolstered by higher infrastructure outlays and a new pension system based on beneficiaries' prior contributions that should boost savings. On the supply side, growth in wholesale and retail trade and in finance is expected to expand services by 5.5% in 2019, easing to 5.1% in 2020. A rebound in construction is projected to boost growth in industry to 5.9% this year, easing to 5.4% next year. Higher investment should accelerate growth in agriculture to 2.6% and then 2.8% with favorable weather.

Inflation is projected to accelerate somewhat to 3.2% in 2019 before slowing again to 3.0% in 2020 (Figure 3.3.8). Further tightening of credit standards should cut credit growth to 13.0% in 2019 and 12.5% in 2020. Bread price increases beginning in December 2018 and higher excise taxes on tobacco may add to inflationary pressures. Inflation could also be higher if economic growth or prices for petroleum or food exceed expectations, or if the lari depreciates further because of monetary tightening in the US or Europe.

With little change in growth and less imported inflation as global expansion slows, the gradual transition to an accommodative monetary policy is expected. The central bank is likely to reduce the policy rate gradually to 6.0% at the end of 2020 if inflation remains below 3.0%. Broad money (M3) growth is projected to slow to 12.0% in 2019 and 11.0% in 2020, reflecting a decline in net foreign assets and less growth in private sector credit, particularly to households, but also with tighter control of state enterprise balance sheets. Continuing efforts should succeed in rolling back dollarization and mitigating borrowers' exposure to foreign exchange risks, in part by developing a local capital market regulated to prevent excessive credit growth. Foreign exchange intervention will likely be limited to smoothing exchange rate volatility and augmenting international reserves.

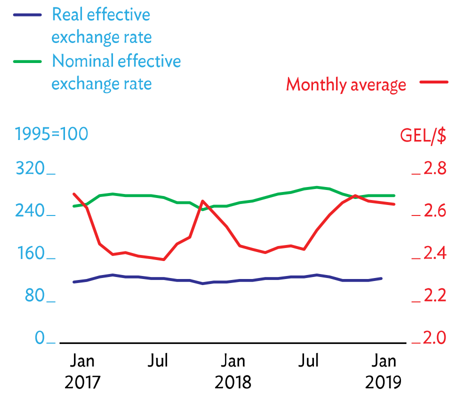
Over the next 2 years, fiscal policy will become more expansionary and reallocate spending toward infrastructure and education. The fiscal deficit is expected to rise slightly to

3.3.1 Selected economic indicators (%)

	2019	2020
GDP growth	5.0	4.9
Inflation	3.2	3.0
Current account balance (share of GDP)	–7.9	–7.8

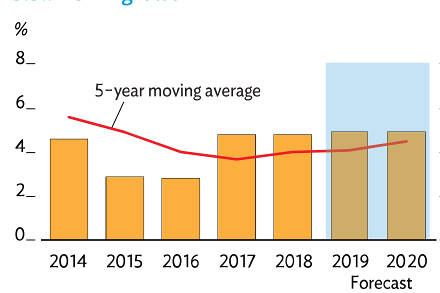
Source: ADB estimates.

3.3.6 Exchange rate



Source: National Bank of Georgia. https://www.nbg.gov.ge (accessed 7 March 2019).

3.3.7 GDP growth



Sources: National Statistics Office of Georgia; ADB estimates.

equal 1.0% of GDP in both 2019 and 2020 to enable additional capital spending. While the wage bill and most other current outlays will be contained, social spending is expected to rise by the equivalent of 0.4% of GDP in both years to cover higher pensions and salaries for teachers. By promoting private investment, a public–private partnership law enacted in 2018 is expected to moderate contingent liabilities, off-budget operations, and the balance sheet of the public sector while strengthening the framework for managing public investment projects. Public debt is nevertheless expected to reach the equivalent of 43.6% of GDP in 2019 before easing to 43.3% in 2020 as foreign debt declines (Figure 3.3.9).

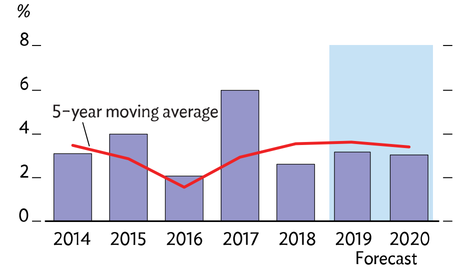
The current account deficit is forecast to continue to narrow to 7.9% of GDP in 2019 and 7.8% in 2020 as strong growth endures in exports, tourism, and remittances (Figure 3.3.10). Exports of goods and services are projected to rise by 6.1% in 2019 and 11.3% in 2020 with growth in Georgia's trade partners. Despite continued expansion, import growth is projected to plunge by two-thirds to 4.7% in 2019, reflecting slower growth in petroleum and pharmaceuticals, before recovering to 8.6% in 2020. Growth in remittances is projected to diminish to 1.3% in 2019 with slower growth in the Russian Federation and further afield in Italy and Greece, then rise by 6.9% in 2020 as the external environment strengthens. Continued recovery in Azerbaijan and, to a lesser extent, the Russian Federation is expected to offset risks posed by a deeper slowdown in Turkey. Gross reserves are projected to increase to $3.5 billion in 2019 and $3.8 billion in 2020 (Figure 3.3.11).

Downside risks to the forecast could emerge from external shocks and escalating trade tensions, tighter credit, rising global interest rates, difficulties in financial markets, or reduced capital spending. However, growth could be higher than forecast if the outlook improves for key trade partners such as Azerbaijan and the Russian Federation.

Policy challenge—improving skills to mobilize foreign direct investment into high-value sectors

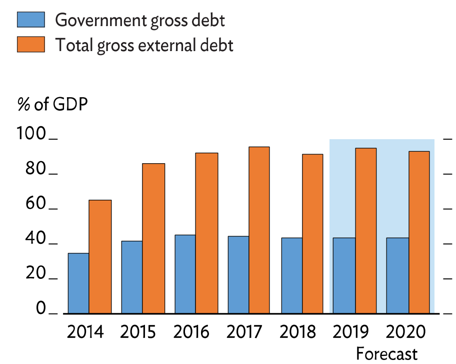
Despite its relatively attractive business climate, Georgia's economy remains poorly diversified, its exports concentrated in few products and providing only a small share of GDP. Foreign direct investment (FDI), an important source of capital for Georgia because of low domestic investment and limited savings, nearly tripled from 2005 to 2018. However, FDI goes mainly into existing labor-intensive activities, rather than more complex sectors of the economy that add more value, such as manufacturing (Figure 3.3.12).

3.3.8 Inflation



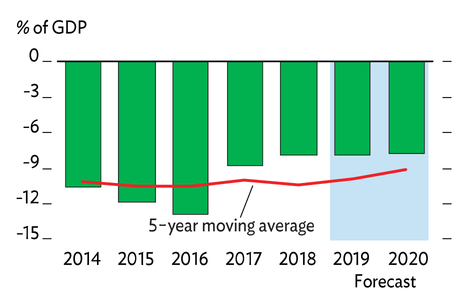
Sources: National Statistics Office of Georgia; ADB estimates.

3.3.9 Government gross debt and total external debt



Sources: Ministry of Finance of Georgia. www.mof.ge; International Monetary Fund. www.imf.org (both accessed 7 March 2019).

3.3.10 Current account balance



Sources: National Bank of Georgia; ADB estimates.

An obstacle to attracting FDI for diversification is the shortage of qualified workers graduating from Georgia's educational system. With limited education and training, most of the workforce remains in sectors with low productivity such as subsistence agriculture, leaving a shortage of skilled workers for manufacturing and other activities with greater product complexity. Also inhibiting diversification are the relatively high cost of logistics and documentary compliance for imports.

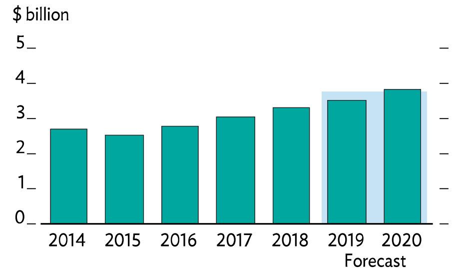
While Georgia has done much to develop an attractive business environment, it lags in supporting research and development, training workers, and promoting innovation. In the World Economic Forum's *Global Competitiveness Report 2018*, Georgia ranked 66 of 140 economies in the quality of its education system and 85 in innovation capability. An inadequately educated workforce was among the key constraints for doing business.

The government has taken steps to address skills mismatch in the workforce. In 2018, it announced a new and comprehensive strategy covering all levels of schooling to boost the quality of education. In addition, the Ministry of Education, Science, Culture, and Sport has implemented a number of reforms aiming to integrate general and vocation education by creating associate degree programs and promoting professional training. It has instituted a work-based learning model and offers state accreditation for privately provided certificate programs. A program called Digital Society assesses labor market trends and the ability of the education management information system to provide analysis and suggestions for change. Further, the government is developing occupational safety standards for institutions offering technical and vocational education and training, and it seeks to outsource the management of technical colleges.

Georgia's Innovation and Technology Agency strives to improve workforce skills by promoting information, computer, and digital technology and training in science, technology, engineering, and mathematics. It supports the development of innovative products with startup funding for creative projects and promotes collaboration between universities and businesses in research and development. These reforms are helping to develop electronic business and e-commerce to support diversification.

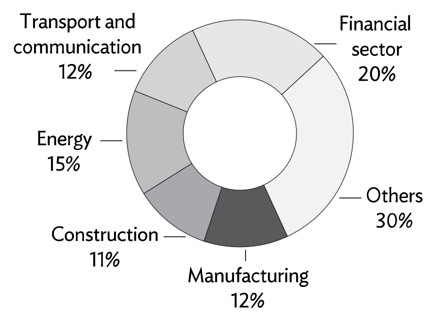
Stronger private sector involvement in training for entrepreneurship would help, as would efforts to encourage more women to enter business.

3.3.11 Gross international reserves



Sources: National Bank of Georgia. www.nbg.gov.ge; International Monetary Fund. www.imf.org (both accessed 7 March 2019); ADB estimates.

3.3.12 Foreign direct investments by sector



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 7 March 2019).